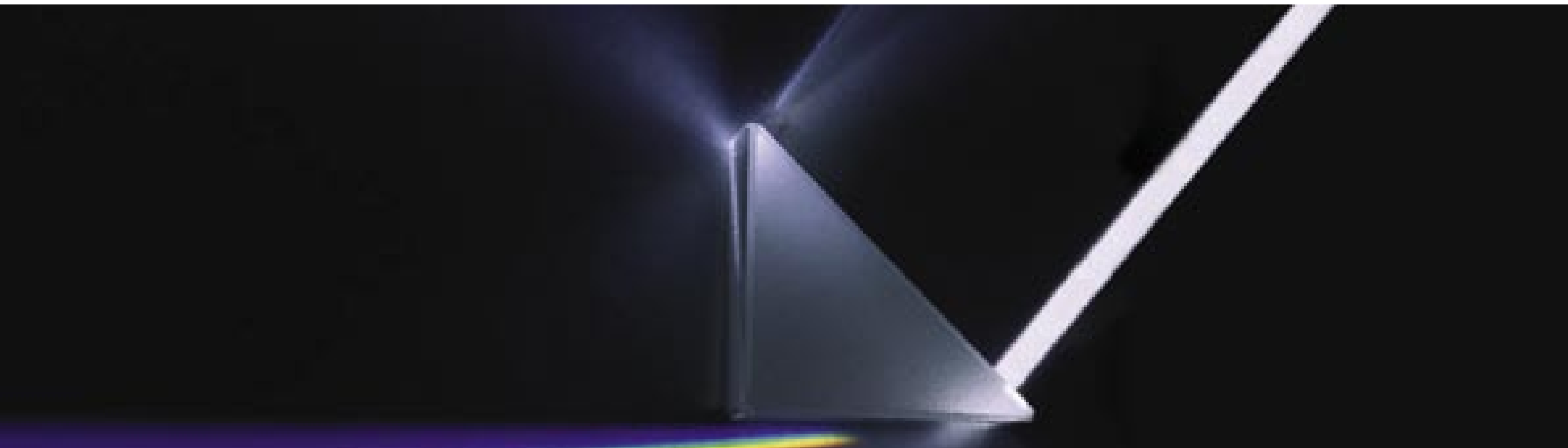
Performance Transformations



McKinsey&Company

Performance Transformations

In this age of intensifying competition and unparalleled pressure on corporate leaders, the need for periodic performance transformation is increasing. A strategy limited to the pursuit of incremental year-on-year performance gains will not work over the long haul. At critical points, companies need to boost their performance to a distinctly higher level in order to fend off competitors and stay in the game.

Unfortunately, there is widespread pessimism about the prospects of transformation efforts. After all, there are prominent cases of once highly-admired companies that have failed to transform themselves despite multiple attempts. Many companies not only slip down the corporate rankings, but actually plummet down them or disappear entirely. Sixty-one of the 1987 Forbes 100 had fallen from their place by 2003.

A sober realism is prudent, but we believe there are solid grounds for hope. Consider, first of all, the size of the prize. In virtually any industry, there is significant performance improvement potential not only for the weaker performers but even for the leaders. In the banking sector, for example, a company could multiply its operating-profit-to-total-revenues ratio six-fold by moving from the lowest industry quartile to the top. Even the best performers have significant headroom, if only they aim high enough. If a top-quartile bank could combine the sector's peak income per employee productivity with its highest labor cost efficiency, performance could rise by 50%.

Reaching multiple performance peaks in this way may seem merely theoretical, but there are plenty of real-world examples where excellent companies have redefined what is achievable. A prominent e-commerce company received the highest customer satisfaction score ever for a service company a few years ago. Yet even as its major competitor was closing the gap, it jumped ahead by breaking its own record two years later. Even more strikingly, this company significantly lowered the costs of its operating model in tandem with these customer service breakthroughs. The per-unit cost of one key operating process fell by 40% over the period.

For most companies, of course, the room for transformational improvement is clearer, and we have seen strikingly successful transformations in many industries, including some that are mature and slow-moving. A mid-tier energy company has become an industry giant with a widely-envied performance model. A European postal service addressed severe operational, organizational, and financial challenges to become a strong performer with significant prospects in only three years. A partly state-owned telecommunications company became a leading private multinational in only five years. A country's worst-performing bank has become one of the world's best.

So despite the poor average results of transformation efforts, we have observed so many successes in so many industries and from so many different starting points that we have concluded that transformation is a real possibility for virtually any company. The intriguing practical question is therefore: what has made success possible for such a diverse range of companies? To answer this question, we conducted intensive research (see below).

Our research reinforced what the experience of scores of transformations had taught us: the key to success in transforming an organization is the leader's ability to create, sustain and channel its energy, the fuel that drives true and lasting change. What we found is that the use of six powerful catalysts releases that energy: companies must (1) achieve rigor in their program architecture, (2) combine an emphasis on performance with a focus on corporate health, (3) set aspirations and the right pace to meet them, (4) embed change into the workings and processes of the organization, (5) change employees' behavior, and (6) transform the company's leadership.

At McKinsey we have supported scores of major transformation efforts at our clients over the years. We thus have extensive first-hand experience of the scale of the challenges and benefits involved.

Over the past decade we have conducted a series of research projects around the operational, organizational and leadership elements of transformation. Specific topics included "lean" manufacturing techniques, innovation, operational transformation, continuous improvement, leadership development, emerging organizational forms, front-line engagement, and cultural change. Over the course of this work dozens of case studies were developed, over a thousand managers were surveyed or interviewed, and some 35 professors from 15 leading business schools were consulted.

Over the past 18 months we have undertaken an effort to synthesize the findings of these projects as an integrated perspective on performance transformation. This article is one of the results of that effort.

In successful transformations…	
1 Rigor in program architecture	… the architecture is articulated at three consistent levels: an overall change agenda, a set of core performance themes and an array of individual initiatives
2 Performance and health	… both performance and health are lifted to new levels in an integrated way rather than traded off against each other as conflicting goals
3 Aspirations and pace	… a powerful, long-term performance vision is rolled back to a desired "mid-term future state" that is more granular and actionable, yet also stretching in terms of both the scale and the pace of change
4 Embedding change	… from an early stage, highly visible manifestations of change in the operating model lock in higher performance, create energy, facilitate learning and foster yet more change
5 Making change personal	… mindsets and behaviors are changed through a holistic approach that addresses employees' understanding and commitment; the systems and structures that guide their actions; their skills and competencies; and their need for influential role models
6 Transforming leadership	… leadership is a resource that is not only tapped to propel the change but can also be systematically increased in terms of both volume and depth

What our six catalysts provide is a framework of insights which goes beyond the familiar, explains the subtleties of implementation and emphasizes the pitfalls of misinterpretation and incomplete application.

As we consider each one in turn, it becomes clear that there is no silver bullet in transformation, no single pivotal action or event that can guarantee success. Transformation is not "all about" an energizing vision or change champions or indeed any of the other panaceas that have been trumpeted in the past. Transformational change is difficult for multiple reasons and stretches leaders in multiple ways.

1 Rigor in program architecture

A rigorous program architecture is needed to ensure that the transformation effort is actually carrying the company forward rather than just expending energy. In many change efforts energy is dissipated by poor design. Some companies, for example, hope to release pent-up entrepreneurial agency, and so “let a thousand flowers bloom.” Despite their good intentions, however, such companies may well end up facing “death by a thousand initiatives,” as their well-intentioned impulses splinter into a multitude of parallel projects that lack the scope needed to transform the organization.

The rigor that is needed to overcome such a lack of discipline does not, however, involve exhaustive micro-programming of every facet of the program architecture. Indeed, out-of-control architectural design efforts can bog down a transformation in energy-sapping bureaucracy. Instead, the necessary rigor has been achieved when each of three distinct levels of a program architecture has been developed in sufficient detail to support productive action.

The highest level is the change agenda – the level at which the “story” of the transformation will be told. For example, a regional machinery company with outstanding products but limited value creation undertook to transform itself into a global leader in equipment and services for the oil and gas industry. Next are the “chapters” of the transformation story – its core performance themes (typically three to six), such as boosting geographic reach, achieving operational excellence, and building the service business. These themes are more powerful than conventional change slogans because they describe the future transformed state of the company in vivid but credible terms. Closest to the ground are the individual initiatives that will deliver the transformation story – perhaps five to ten for each theme. Some examples: project management improvement, designing to cost, and procurement initiatives. These concrete, high-impact initiatives turn the change agenda into reality on the front lines.

This articulation of the architecture into three levels has several benefits. It fits well with the multiple time-frames that are simultaneously in use in the company: the change agenda matches the company’s strategic eras (typically 5-10 years); the transformation themes correspond to managers’ time horizons (2 to 4 years); while the initiatives fit with project life-cycles (6 to 30 months). This articulation makes it possible to move fast without losing control of the effort, as a relatively rapid sequence of initiatives at the lowest level is compatible with slower change in the transformation themes and great stability in the change agenda. In addition, architecting the program in these levels helps managers break free from the pernicious habit of confining initiatives within organizational boundaries. Moreover, it reconciles the need for company-specific customization in the change agenda and transformation themes with the opportunity to adopt tried-and-true approaches for the specific initiatives. Finally, it makes it possible to achieve real alignment among managers who are contributing to the transformation in very different ways.

The CEO of a telecommunications company had the overarching goal of achieving profitable growth within three years. Underneath this goal he designed four themes: becoming a high-performing and committed organization; growing through broadband and innovation; making dramatic improvements in efficiency; and improving quality and customer satisfaction. Each theme was further structured into a number of supporting initiatives. This approach helped the company’s employees understand how their efforts fit into the transformation process and mobilized them to act at a rapid pace.

The results have been outstanding: the company has become one of the most efficient telcos, and the only one of its group to increase both revenues and margins over the period of the transformation. The time and effort the CEO invested in program architecture at the beginning paid off before the effort was halfway through.

2 Performance and health

We often hear top managers say that pressure to achieve quarterly results can become so overwhelming that it is nearly impossible to devote any attention to longer-term goals. Focusing on the quantitative targets that align employee incentives with shareholder value can indeed produce results for a while. The problem, though, is that this approach harvests the fruits of the business without planting seeds for the future. The long-term consequence of this approach can be an abrupt decline, followed by years of painful recovery.

CEOs need to recognize that performance (delivering results) and health (developing the potential to sustain and improve performance) are not in conflict: they are complementary. Effective performance transformation helps to clarify a company's priorities, and so makes it possible to focus on performance and health with equal intensity. Sports teams must win games while investing in players and facilities, and governments must provide services while also building and maintaining social and physical infrastructure. Similarly, businesses must meet performance expectations while also inspiring their employees, investing in research, and protecting and enhancing such longer-term assets as the brand. Indeed, it could not be otherwise because better and better results depend directly upon better and better capabilities.

A surprisingly abrupt end to long years of performance gains can often be interpreted in these terms. The progressive erosion of health remains invisible until it suddenly causes a collapse in performance. On the other hand, we also see transformations where enhanced corporate health is acknowledged as a central goal but understood much too narrowly in terms of the organizational climate. Here, the program architecture may be so biased towards "feel good" initiatives that have little connection to the real work of the company that there is no effect on performance at all. All the organizational buzz around an exciting series of cascading workshops may deliver precisely nothing in the results column. Even the effect on health may ultimately be negative as the organization becomes more cynical and loses change energy.

As always, knowing what to measure – what success looks like – is critical. Companies in general find it easier to assess their performance gaps than to diagnose their health problems. That is, they may readily discover where they are falling short, but have at best a rough idea of what it is in their practices, culture and history that is holding them back. As they develop their aspirations and design their program architecture, corporate leaders must ask themselves, "Why is this transformation likely to be difficult for us?" Every successful transformation requires a brutally honest and highly specific answer to this awkward question. At bottom, it is a question about health: it is directed at the critical capabilities that will be the most difficult to build, and about the understanding, confidence and commitment that will be needed among managers and employees to actually build them.

Consider the example of the new CEO of a universal bank of 70,000 employees. Recruited for his hard-driving reputation, he doubled economic profit over four years, while reducing costs by 22%. This focus on performance, however, was putting the company's health at risk: not only did the top line fail to move, but the company was losing ground with its customers, employees, and community. A survey revealed that only 17% of the bank's customers would recommend it to a friend, and only 13% of the staff would recommend it to a family member.

Recognizing the importance of this problem, the CEO broadened performance management and incentive systems and dramatically increased the level of training and communication. The product line was improved to better meet customers' needs. The result: organic growth rose from 3% to 7%, and a new survey showed that the employees who were proud to work for the bank rose from 11% to 87%. Thanks to these efforts, performance and health were back in balance, and the bank could look forward to sustainable good results.

3 Aspirations and pace

Efforts to transform companies are often undermined by incrementalism or by the failure to translate ambitious but rather general aspirations into stretch objectives that are compelling and actionable.

Leaders of successful transformations help take performance to new heights by developing a performance vision for the long run and then working backwards from that vision to define a desired mid-term future state for each transformation theme. Because such a future state is "nearer and clearer" than the performance vision, it has the immediacy and concreteness needed to inspire stakeholders, set a rapid pace for change, break through resistance, and encourage an action-oriented mentality right down to the front line. On top of this general effect on energy, it is more actionable: it is near enough in time for managers to identify specific initiatives and set operating goals for it.

Unfortunately, the crucial distinction between the performance vision and the mid-term future state is routinely lost in accounts of successful transformations. Corporate leaders who are justifiably proud of their success articulate their performance vision in retrospect with penetrating clarity and sometimes give the impression that this clarity was achieved at the outset. Indeed, they may have so fully internalized their vision that they have forgotten how much of its detail they filled in along the way. In reality, in the beginning they may have been very clear about the first mid-term future state but not about the further-out and much more challenging performance vision. Yet in hindsight the performance vision is misremembered as fully formed in its earliest formulation, and the series of mid-term future states that made real change possible are lost from view.

If at all times a company is working towards the next mid-term future state, why bother defining a performance vision at all? The development of the performance vision ensures that this is not just an isolated performance initiative, but rather the first major stage in a longer process. Ultimately, a transformation effort cannot be considered a major success unless it moves the company beyond what it can fully imagine at the starting point. A transformation is a journey in which clarity around the

performance vision grows as each fresh expanse of the landscape comes into view. Making sure that the vision outstretches current capabilities can be an energizing spur to such progressive learning.

Indeed, there is a paradox here. The journey does not even begin unless there is a commitment to a performance vision that lies well beyond the company's immediate reach. Even the mid-term future state must amount to a real stretch for the company because easily attainable goals spark little energy: there is no drama in reaching them, and no vital sense of danger about falling short of them. Leaders must therefore have the courage to set aspirations for both the mid-term future state and the performance vision high enough to be truly energizing. This contrasts sharply with the incrementalist approach, where making the "increment" easily achievable is mistakenly believed to create more energy.

It may take five or more years to approach some performance visions even at a fast pace, but much more rapid progress is sometimes feasible. We have seen companies make huge strides within two or three years. For example, the national postal system mentioned above had been famous for its dysfunctionality. It aspired to achieve its performance vision of transforming all of its offices within two and a half years, and to raise service and profitability levels in its branches to enable a growth strategy in financial services. Specific metrics were both ambitious and clear: the offices should offer more functions than bank branches, at 30% of the cost. Queuing time for 80% of customers would not exceed 7.5 minutes. And growth was to rise to 5% per year – from the current 2% decline.

The results lived up to the aspirations. Two million checking accounts were opened, and in only two years the post office became the country's number three insurance provider. Productivity rose by 30%, revenues by 20%. The Financial Times wrote that "the post office is shaking the banking industry," and the country's prime minister observed that its citizens had "one less topic to talk about: no more queues in the post offices."

One element in making aspirations truly stretching, therefore, is setting an energizing pace. Moving fast forces managers to look beyond mere fine-tuning to major leaps forward, and builds their confidence as they discover that they can, indeed, move far faster and accomplish more than they had dared to hope.

4 Embedding change

The foregoing discussions of health and aspirations highlight the crucial intangible side of transformations, but of course successful ones are also highly tangible. They are rooted in operational changes and quickly take on physical shape. Reconfiguring physical assets, relocating staff to the frontline, making quality performance visible, changing logos and IT tools, bringing customers into the workplace, improving the layout of the office: all these things matter, yet companies often ignore them.

Embedding changes in operational processes is of course essential for locking them in, but it is also a highly effective way of showing customers and employees that there is no going back to the way things used to be. This kind of change is much easier to accept – and much harder to reverse – than changes that are simply conceptual. Moreover, if the new way of doing things is properly thought through it is also the easiest way, and thus comes naturally once new habits have been formed.

As indicated, there are many different ways to embed change in physical processes. However, one frequent visible change employed in an increasing range of industries is incorporating 'lean' thinking into operational processes. Lean began as an automotive-inspired and assembly-oriented initiative but has become well-established in a range of financial, process and service industries and also in the public sector. While the concepts of lean are familiar, its success depends not just on rolling out new approaches, but on changing both the environment and the basic ways of working. It is this immediate physical impact that distinguishes lean from activity-based processes such as TQM and Six Sigma, which, when poorly embedded, generate reassuring activity and enthusiasm but lack tangible, lasting benefit. Managers must make their employees aware that a problem exists, prove the benefits of the new approach, and create the conditions for embedding the change. At a manufacturing company, this meant taking very practical steps: finding the right tools for the job, making the equipment more reliable, avoiding unnecessary changeovers, and planning production more effectively. Making these changes not only reduced waste; it also raised the baseline for the next set of changes.

In successful transformations, this embedding of change is not a decisive final stage in a long linear process. As we have seen, clarity about the performance vision grows step by step as the program proceeds. This learning comes in substantial part from changing the way things are done, assessing the outcome, and changing them again. In the real world, organizational learning is as operational as it is conceptual, that is, as much an outcome of practice as of thinking. That in itself provides a compelling case for embedding change iteratively from an early stage in the transformation. The case becomes all the stronger when the energizing effect of successful change is factored in. Well-embedded change is powerfully catalytic because there is no going back. A bridge has been burned.

5 Making change personal

Ultimately, change takes place – and persists – only when people's hearts and minds are captured. It's not enough to have people in an organization recognize that there is a new management team that hopes to see change. At some point, the light must come on so that things that were neither intuitive nor obvious suddenly make sense. That's when each person will understand where he's going, figure out what he has to do to get there, and then really live the changes that will be necessary for the overall transformation to happen.

Getting employees to change their mindsets and behavior takes four key elements. The first is understanding and commitment: people must know what they need to change, and really want to do it. Second, they need systems and structures that are aligned and consistent with the new behavior the organization expects. Third, employees must believe that they have the skills and competencies necessary to behave differently. Finally, they need role models: it's crucial to see leaders are behaving in the new ways. If any of these elements is missing, a shift in individual mindsets and behaviors is unlikely to take place.

Although these shifts must take place at the individual level, the group in which the individual works has a strong influence on their effectiveness. In practice, individuals in working groups trigger and reinforce change in each other (or alternatively block it). That is why influencing the group as a group is a proven technique. We have found that this principle of group-level change is all the more powerful when extended to groups of groups, such as plant locations or sets of branches or outlets. A series of "mini-transformations" at this level delivers much better performance results over time than a conventional roll-out approach.

In a recent large-scale transformation, a leading European public agency made change personal in multiple ways. It involved all 90,000 employees in an electronic dialogue, with the goal of understanding how they felt about the agency's performance, their own performance, and the transformation process. Employees were also surveyed to help with the organization design. The agency ran over 2,000 workshops in which the local leadership teams explored their business and leadership performance, and then developed programs that would deliver improvements in both these areas. The result was the largest mobilization of mid-level leaders the organization had ever experienced. The agency also created a network of over 800 change agents who were systematically trained to overcome challenges in the transformation of the agency's local branches – more than 180 in all. As a result of these efforts, the change program was irreversibly set in gear.

6 Transforming leadership

Many change initiatives fail because the challenges and opportunities are greater than the capacity of existing leaders to address them. When there is no real leadership, and when leaders do not have the courage to convert or remove the people who block change, the organization can quickly run out of energy.

Inadequate leadership capacity is a classic chicken-or-egg problem: leaders are needed to drive transformation, but greater leadership capacity is itself an output of transformation. In practice, however, a rigorous assessment of the demand for leadership (the pivotal jobs that have the greatest impact on performance) and its supply (the company's strongest managerial talent) generally reveals that there are immediate opportunities for triggering a virtuous spiral in which performance improvement and growth in leadership capacity reinforce each other. The key is to design the transformation with this spiral in mind.

Great CEOs in fact use transformation as a compelling opportunity to expand leadership capacity and to align and energize leaders in their top teams and throughout the organization. They achieve this by ensuring that the program is as transformational for these leaders as it is for the company as a whole. Those who can make the leap learn to lead at an entirely new level, while more appropriate situations are found for those who cannot.

The CEO of an Asian oil company, for example, understood the need to develop leaders who could take on its ambitious portfolio of initiatives. To meet this challenge, he initiated a range of highly effective changes and personally hosted an "opportunity fair" of initiatives, requiring leaders to step forward to take on new tasks. He revised the performance contracts of the company's officers, putting 10% of their bonuses at risk based on their success at coaching and mentoring potential leaders among the executives they supervised. These new approaches had a profound impact on the company's leadership culture and helped to foster the emergence of leadership even among employees outside the managerial ranks. Unlike many less successful change leaders, this CEO recognized that the organization's leadership capacity could be dramatically increased to support its aspirations. Indeed, he saw the transformation program as an unparalleled opportunity to drive this growth, and his actions have built a cadre of leaders who will help sustain and further increase performance gains.

We believe the six catalysts described in this paper provide the right framework for a CEO seeking to transform corporate performance. Our research and experience suggest, moreover, that the six need to be systematically introduced and integrated with each other to achieve maximum impact, and that precise tailoring to the company's individual context and circumstances will also be required.

These are just some of the issues that make the decision to embark on a transformation one of the most momentous a CEO can make. No other effort requires such strong and dedicated leadership from the top. Any CEO considering a transformation should therefore think hard not only about the necessity for transformation but also about its benefits. Since a transformation changes the basic character of the company, the CEO must be aware of where leadership interventions will be most painful and have make or break implications for the whole program. Since these interventions affect the corporate culture and the leadership style of many managers, this requires an intimate knowledge of the organization as well as a commitment to changing it.

Making the case for change and communicating it in a compelling way, indeed, may require changes in the CEO's own preferred leadership style and the overturning of past decisions. Once the transformation has been announced, the organization will closely observe the CEO and the top team for signals that confirm or disconfirm commitment to the new course. Any reversion to the old way of doing things, even if justifiable in the particular case as a temporary expedient, will count as evidence that "this too shall pass." This and other kinds of "moments of truth" (involving, for example, how the CEO and the top team deal with the inevitable setbacks along the way) cannot be avoided or put off. They must be tackled directly, one by one.

So it is not just the scale and variety of predictable challenges that the CEO must ponder before committing to a transformation. The CEO must also ask, "Am I really ready to take on each new challenge that surprises me along the way during this transformational journey?" The personal cost is indeed high, but the opportunity is also immense.

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Organization_Practice@McKinsey.com

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